The Bank-Based Financial System and Kinyu Keiretsu: Political Economy of the Bank-Centered Cross-Shareholding System in Postwar Japan

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Abstract
In the 1980s, Japanese financial institutions and *keiretsu* firms had to face domestic and international structural challenges, which occurred because of the structural changes in the *keiretsu* production system such as outsourcing and downsizing, as well as monetary and financial factors due to major financial liberalization reforms.

Keywords: *keiretsu*, structural changes, outsourcing and downsizing, financial liberalization

Introduction: The Keiretsu Organizations

The *zaibatsu* and the wartime economic system were the two main elements in Japan's economic modernization during the prewar era. Many well-known Japanese economists and historians, such as Aoki (1988), Noguchi (1998), and Okazaki (1994a, 1994b) have focused on the fundamental structural changes in the Japanese capitalist paradigm during the inter-war period and the Second World War. They believed that the primary distinctiveness of the system survived the war and continued to influence important elements of the economy of postwar Japan. They argued that important features of the postwar economic institutions in Japan, such as the *keiretsu* organizations and the main bank system, characterized by "high debt/equity ratios, greater reliance on bank loans than securities markets, a closer relationship between banks and borrowers, extensive corporate cross-shareholding, [and] greater guidance from the government in credit allocation, etc." (Monzur 2004:4) emerged during and shortly after these periods due to the consequences of the wartime regulations.

Noguchi (1998), for example, pointed out that the relics of the wartime economic structure, such as close cooperation between the state, big business and the banking industry, still continued to provide the basic outlines of the present economic system. The Japanese economic system, which was initially intended to fight a total war, survived to play a fundamental role in the Japanese economy during the high growth era. The aim of mobilizing the total power of the national economy changed from military to economic after WWII, but the main formation of the system itself has continued to dominate the modern Japanese economy.

The dissolving of the *zaibatsu* and rise of bank-centered financing were the result of the most important structural changes in the Japanese economy during this period. Wartime regulations had weakened *zaibatsu* organization by lessening the control of the *zaibatsu* families over the holding companies and increasing managerial control over Japanese corporate governance. By the end of the war, Japan had fully achieved "managerial capitalism" (Abe 1997:303). These major modifications restructured the Japanese economic and financial system and increased the importance of cross- shareholding and bank-centered financing in the postwar era. Many economists agree that, with this new corporate governance and finance system, the Japanese economy obtained the strategic flexibility and competitive advantage to become a global economic power. For example, Ozawa (1999) argued that the strengthening of capital-intensive, scale-driven heavy and chemical industries in the early postwar period required high levels of technical and management skills and massive amounts of capital, and entailed high financial risks. The *keiretsu* and the main bank system, together with close cooperation with the state, reduced this financial risk and made Japan able to complete its industrialization process successfully.

As a consequence of the *keiretsu* success during the high growth era, the Japanese corporate governance model and aspects of Japanese industrial organization were often acclaimed as "alternative models" to Western-style capitalism for sustainable economic development and corporate success (Cowling and Tomlinson 2002:374). Caves and Uekusa (1976) argued that the *keiretsu* firms were one of the most "conspicuous forces" in Japan's rapid industrial development and transformation. During the high growth era, *keiretsu* firms and the main bank system took over the role of allocation in Japan's development strategy. Johnson (1982), Sheard (1991), Dow (2003) and many other economists considered the Japanese *keiretsu* system as a source of "strategic advantage" for the Japanese firms in the global arena. They argued that their organizational structure and also their relations with the Japanese government created competitive advantages for the *keiretsu* firms to compete with multinational firms in domestic and international markets.

The Horizontal and the Vertical *Keiretsu* Organizational Structure

Keiretsu groups are commonly divided into horizontal and vertical *keiretsu* groups, according to their organizational structure. Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, and Dai-Ichi Kangyo Bank Groups are the most widely cited horizontally organized bank-centered *keiretsu* groups. Gerlach (1992a) and Hoshi et al. (1991) note that about sixty percent of the 200 largest industrial firms and almost all the leading financial institutions have strong business connections with a horizontal *keiretsu*. Gerlach (1992a) has pointed out that these "big six" groups are estimated to account for 15 percent of total corporate assets and 50 percent of total corporate sales in the Japanese economy.

Hoshi and Kashyap (2004) argue that there are significant structural differences between *zaibatsu* and *keiretsu* groups. In particular, the *keiretsu* group companies are more autonomous than the *zaibatsu* firms because of differences in their corporate governance structures. Unlike the *zaibatsu* network, there is no single family or firm which has the majority of the controlling stock, and there is no central authority like a "holding company with the power to direct the other firms" (Hoshi and Kashyap 2001:11). They do not have a hierarchical structure, and each member firm has an equal relationship in shareholding and transactions (Abe 1997:303). In most of the cases, the main banks and general trading companies (*sogo shosha*; Dicken and Miyamachi 1998:56) were the biggest shareholders with the authority to monitor and ultimately control the companies' corporate governance and investment decisions. "A *keiretsu* member firm obtains most of its capital from other members, including the main bank, which is typically the largest lender and holds a substantial equity stake in the firm" (Osano and Hori 2002:11). Each of these *keiretsu* groups had several core firms (such as a large bank, a trading house, and a heavy machinery company), but no company was dominant in terms of its ownership stake; rather, each group member owned, on average, 1-2% of the shares of other group members" (Schaede 2006:29).

The member firms were autonomous to make operational decisions but they were most likely to follow the long-term strategy for the entire group. "This structural autonomy and group connection give a competitive edge to each member firm in a number of aspects of their operations, such as providing in-group loans from the main banks, offering member firms domestic markets for the products, and offering international marketing capabilities." (McGuire 2002:33) The group companies usually avoid competing with each other in the same sector, which is known as "one-setism" (Schaede 2006:29). "In this way, interdependencies are managed not through control over single markets, but through the spreading of risk across weakly correlated economic sectors" (Gerlach 1992b:115).

The Vertical *Keiretsu* Network

The vertical corporate governance model was developed by Toyota during the 1930s and shortly after became common among other big firms in the military, automobile and electronic industries. Big companies, especially the *zaibatsu* firms which produced weapons for the Japanese army during the war period, began to subcontract some of their work to smaller firms to increase their production capacity with minimum capital investment. They divided product assembly into discrete steps and each product assembly was carried out by a separate contractor firm. This transaction system initially persisted after the war since it gave a competitive advantage to the apex firms during business expansion. Therefore this type of organization became very common in the automobile, consumer electronics, and petrochemical industries. In the post-war era, the *keiretsu* firms "became the centre of all Japanese industrial production and began to dominate economic decision-making, often dictating the conditions of contract and modes of production to their *keiretsu* partners" (Cowling and Tomlinson 2000:367). "Vertical *keiretsu* groups controlled most of the industrial production and also distribution *keiretsu*, a subgroup of vertical *keiretsu*, controlled much of Japanese retailing."[1] Toyota, Honda, Nissan, Matsushita, Sony, Fujitsu, Sharp, Sanyo, Hitachi, Mitsui, Idemitsu and Maruzen are some of the well-known vertical *keiretsu* groups in Japan.

Aoki (1984), Lawrence (1993) and also Mori (1994) argue that this kind of coordinated enterprise provided many benefits to the apex firms and their suppliers.

[1] http://searchcio-midmarket.techtarget.com/sDefinition/0,,sid183_gci518852,00.html

Close links between apex firms and contractors diminished the transactions costs, increased the research and level of the technology transfer, and amplified the investments by providing the financing and sharing the risk. Mori (1999:2) suggested that "it is a better competitive strategy for a large company to contract large portions of its products to a smaller company, because it can reduce production costs more effectively if the quality of goods or services is uniform. It is also natural that the contracted companies give other still smaller companies production orders, assuming that the quality remains the same." This method of "procuring parts from outside suppliers is more flexible and open than the method of organizing in-house divisions to manufacture parts." Also, vertical *keiretsu* give low cost internal equity finance and increase cash flows of member firms so they can invest more in R&D and technology transfer. The apex firms are also able to plan, coordinate and outsource the R&D and new product development. This flexibility gives a strategic advantage to the firm to develop new products in a shorter time period with lower costs. "Vertical *keiretsu* firms are alleged only to coordinate decision making with the firms directly above and directly below them in the pyramid. This decentralized planning is possible because the integration in vertical *keiretsu* is much tighter, with no superfluous firms that are not direct parts of the production chain leading to the final products of the apex firm" (Morck 2005:37). Furthermore: "the core assembler firms often provide the financing that is needed to maintain smooth intra-group production operations. Such collaborative financing, provided at low cost, alleviates the liquidity constraints of firms" (McGuire and Dow 2002:33).

These types of vertical enterprise organizations are more like a pyramid. The core assembler firms often hold controlling blocks of equity in each of their main parts suppliers. Each of these suppliers holds controlling blocks in its suppliers, and those companies can hold controlling blocks in yet another tier of suppliers (Randall and Masao 2003:75). This has the effect of establishing direct lines of communication and allows for the dissemination of corporate strategy through the hierarchy of firms throughout the supply chain (Tomlinson 2002:379). Also, only a small amount of the stock in these suppliers is available to public investors. Therefore the apex firm controls the majority of the suppliers' shares and it is very difficult for hostile takeovers. In some cases, apex firms and their suppliers can work with independent firms, but most of the time independent firms want to sell some of their controlling blocks to the core assembler firms to guarantee their business. For example, "Matsushita Electronics Company, Panasonic, which used to specialize in consumer electronics, had to purchase stock of relevant companies in order to begin to supply them with business electronics. This shows that these industries maintain some traditional Japanese-style relationships" (Mori 1994:2). Also the practice of purchasing the stock of relevant companies is very common in other industries such as in petrochemicals, telecommunications, and automobiles. For example "as in a prewar *zaibatsu*, the Toyoda family has substantial control over Toyota Motors itself. Some of the Toyota *keiretsu* firms are spin-offs from Toyota Motors or from other older *keiretsu* member firms. Others are independent firms that find it advantageous to cement their alliances to Toyota by selling controlling blocks to Toyota firms, and so joining the Toyota *keiretsu*" (Morck 2005:37).

The Inter-Firm Relationships within the Group Companies

Much of the existing literature on *keiretsu* gives attention to their close inter-firm relationships within the group companies and with their main banks. Many economists agree that the *keiretsu* organization structure gives a strategic advantage to the member firms in the international and domestic market. As Shleifer and Vishny (1986), Hoshi et al. (1991), and Aoki et al. (1994) have argued, the close inter-firm relationships within the group companies alleviate incentive, information, and control problems related with agency conflicts, thus serving as effective corporate governance and monitoring mechanisms. Dore (1983), Odagiri (1992), Lawrence (1993), Porter (1994), and Miyajima & Kuroki (2005) have also noted that cross-shareholding also played a vital role in sustaining Japanese management and growth-oriented firm behavior during the high growth era. This corporate governance model allowed *keiretsu* managers to focus on long-term investment decisions rather than stock price maximization, so that it freed them from the pressures of the stock market and the fear of takeovers. Hoshi et al. (1990) have pointed out that group companies invest more than independent firms during an economic crisis and consequently recorded a faster return to normal performance.

Caves and Uekusa (1976), Nakatani, (1984), Sheard (1989), Hoshi et al. (1990), Ahmadjian & Robbins (1999), and Lincoln et al. (1996) have argued that the bank-centered horizontal *keiretsu* group firms have the property of risk-sharing, thus facilitating more risky, long-term, low margin, high growth strategies for member firms and reducing the risk of bankruptcy by giving financial and managerial support to a troubled member firm which encounters economic difficulties. In this situation, *keiretsu* firms carried out the function of an "internal market resource allocator," purchasing more from a troubled firm during an economic crisis. For example, Mitsubishi and Sumitomo member firms and employees purchased more Mitsubishi and Mazda cars when the group car manufacturers faced financial difficulties. Furthermore, Lincoln et al. (1996) argue that internal trade between *keiretsu* companies is frequently used as cross-subsidization within the group to develop growth and market share in new products or in foreign markets. Like Gerlach, (1992a) and Hoshi (1994), McGuire and Dow (2002) note that "In addition, as an internal market, the *keiretsu* provides member firms with access to resources controlled by other members, thereby easing resource constraints and encouraging firm growth" (McGuire and Dow 2002:33). Sheard (1994) and Aoki (1990) suggest that the financial and internal trade links between the *keiretsu* firms, customers and suppliers, and financial institutions provide financial and strategic flexibility to the group firms and thus enhance the overall efficiency of *keiretsu* firms. Also the main firms, especially in the automobile, consumer electronics, and chemical industries, control the sales and distribution of their products by establishing subsidiary firms, even at the retail level. With this strategy, *keiretsu* firms have been able to control new market entries. Lincoln (1996), Lawrence (1991) argue that *keiretsu* have often been portrayed as collusive institutions that impede foreign entry into Japanese markets. Imports and Foreign Direct Investment (FDI) are remarkably insignificant in markets where *keiretsu*-affiliated firms have large market shares. Even "after tariff barriers had been dismantled, Western firms found that entry into industrial markets in Japan was complicated by vertical sourcing relationships in which large Japanese firms had ‘inside’ and ‘outside’ suppliers for most inputs” (Westney 1996:6).

The *Keiretsu* Firms and ‘Main Bank’ Financing

Okazaki (1992), Aoki et al. (1994), Hoshi and Kashyap (2001), and Teranishi (2007) have summarized the evolution of the relations between banks and firms during the high growth era. Aoki et al. (1994:16) argue that, “the Japanese main bank system, which came into being in the early post-World War II period, was not created *de novo* by government fiat or bank-business decisions. It had important historical antecedents as the pre-war banking system and industrial system (including *zaibatsu*) evolved.” Policy measures particularly relevant to the evolution of the main bank system were the promotion of bank consortia for long-term investment loans initiated in the 1930s and the introduction of the designated banking system in 1944 (Aoki 2001:335). During the interwar period, in order to support the military, the military leadership had to increase the financial allocation to the armaments industries. As a consequence, the Japanese government mobilized the national economy to give all the necessary administrative and financial support to munitions suppliers (Okazaki 1992). During the period of Japanese militarism, the capital markets were strictly regulated by the government and gave limited access for firms to assemble funding. As a result, bank-based financing became the major source of finance for most of the major *zaibatsu* firms and other armaments manufacturers.

The legacy of the wartime controls on the capital markets had a substantial impact on the Japanese corporate finance and governance system. The wartime financial system was initially directed toward regulating the distribution of funds, and later strengthened regulations restricting the power of shareholders over corporate managements (Okazaki et al 1999:77). The wartime regulations such as limitations on stockholders’ rights and dividend jurisdiction through the military leadership reduced the attractiveness of capital markets to the investors who consequently shifted their portfolios from the security markets to the banks (Hoshi and Kashyap 2001:570). This transformation was strongly supported by the government because it was easier for the Ministry of Finance to transfer the nation’s savings into the war industries through the banking system. Furthermore the government reduced the influence of the *zaibatsu* family councils over corporate management. In addition to restricting shareholders’ rights and the introduction of an incentive system for workers, the military enabled armaments manufacturers to increase the armaments supply.

Tsutsui (1999:14) argued that the Pacific War and the planned economy had a number of persistent effects on the Japanese corporate finance and governance system. The wartime regulations marked a structural alteration in the financial system by transforming it from market-based financing to central bank-based financing. Important features of the financial structure and policies toward financial markets developed in wartime were continued virtually unchanged during the postwar Allied Occupation. More importantly, many became the foundation and framework for the postwar financial system, persisting virtually to the present, even though the goals of postwar government policy shifted dramatically from military production to civilian, industry-based, rapid economic growth.

Aoki et al. (1994) argued that at the end of the war, the Occupation authorities dissolved the *zaibatsu* and made holding companies illegal, but they could not pursue major structural reforms to alter the financial system. Thus many aspects of the wartime corporate finance and governance system remained intact and continued to dominate the real economy. Only the *zaibatsu* family members lost their share in the *zaibatsu* banks, but the 'big five'[2] *zaibatsu* banks and other city banks retained power and most of their stock was bought by other member firms during the cross-shareholding between the ex-*zaibatsu* network members. Since the banks were allowed to hold 5 percent of stock in non-financial firms, the old *zaibatsu* firms wanted to expand their crossholdings of shares with their banks because widening share ownership had created uncertainties in management ownership relations. As the managements' autonomy grew, so the banks' control of firms was strengthened. (Okazaki et al.1999:83). "This bank holding was instrumental in maintaining and reviving old *zaibatsu* company connections based on mutual stockholding, leading to the post-war *keiretsu* system" (Aoki et al. 1994:45). Subsequent to this, stable crossholding ties meant that there was a significant increase in bank financing among the *keiretsu* network members. By arranging these crossholdings and supplying funds, the banks came to take on the role of leaders of the various *keiretsu* groupings (Okazaki et al.1999:83).

The Ministry of International Trade and Industry and the *Keiretsu* Networks

After the end of the Second World War, the Ministry of International Trade and Industry (MITI) was established by the Japanese government to replace the Ministry of Commerce and Industry. Most of the bureaucrats from the Ministry of Commerce and Industry continued their careers under this new organization and their ideas continued to influence MITI's industrial policies. Johnson (1982) argued that post-war reforms, by curtailing the powers of the *zaibatsu* and eliminating the army from the political scene, created a vacuum which was filled neither by the labor movement, nor by the politicians, but by the bureaucracy, and, in particular, by the Ministry of Finance and MITI. From an early stage, MITI's emphasis was on restructuring the Japanese economy to bring industrial output back to the pre-war level. During the occupation era, MITI and the U.S. Occupation authority had a major divergence on Japan's long term economic development policy. The U.S. mainly wanted to weaken Japan's economic and military sovereignty to counter Japan's influence in the region. They dismantled the *zaibatsu* holding companies, and insisted MITI follow a development model which promoted labor-intensive and lower value-added industries such as textile and garment manufacturing. The MITI bureaucrats opposed this policy and allocated Japan' resources to high value added "strategic" industries such as electronics, chemical industries, iron and steel, shipbuilding, machine tools, cars, electric power, and

[2] Mitsubishi, Mitsui, Sumitomo, Yasuda, and Daiichi were the big five financial monopolies.

petrochemicals to rebuild the Japanese economy (Johnson 1982:229-238). Shigeru Yoshida, who served several terms as prime minister of Japan after World War II, was the chief architect of this resistance (Kopstein and Lichbach 2005:160).

Since then, the Japanese government has supported the *keiretsu* firms in ‘strategic industries’. “These favored industries have been aided with government-sponsored collaborative research projects, R&D subsidies, preferential access to capital and (at least) temporary trade protection” (Lawrence 1993:4). MITI limited the competition and also restricted entry to markets that were considered “strategic.” Ito (1997:17) has summarized how the government targeted and promoted specific sectors and firms. He argues that “Japanese firms either licensed foreign technology or reverse engineered foreign products to catch up. As the economy grew and firms gained experience in production, the successful ones were able to expand. Increasing returns to scale brought down production costs, and returns to scale were further enhanced when these firms started to export and became more competitive in the world market. When the sector reached this stage, restrictions on imports were liberalized.” Krugman (1998) and Ito (1997) argue that although MITI closed the domestic market to international competition, it always wanted several *keiretsu* groups to invest and compete in the same industries, “thus providing the necessary degree of competition without which protectionism and administrative guidance would not have worked” (Bolitho 1985:199).

As Bolitho (1985:190) suggests:

> “The major reason for this policy stemmed from an emphasis on the importance of the internal market which came, in turn, from an implicitly Kaldorian (and Schumpeterian) view of the growth process—that the key to development and international competitiveness is economies of scale in manufacturing, particularly in a few large firms in each branch. Trying to achieve such economies through export growth was too expensive and risky a strategy—it required a high initial level of subsidy, since Japan’s industry was too weak to sustain world market competition, and it relied implicitly on the maintenance of high demand abroad and on the absence of foreign protective barriers, neither of which could be taken for granted in the 1950s. Hence the required scale economies had to be achieved first through domestic market growth, which would provide Japanese industry with sufficiently high levels of demand for the chosen few large firms to reach best-practice technology and internationally competitive cost levels.”

There was a strong positive correlation between MITI’s strategic industries and the *keiretsu* firms’ investments. In the high growth period, the *keiretsu* firms’ strategic emphasis was on the traditional commodities and products such as electronics, petrochemicals, steel, cars and shipbuilding. During and after the first oil crisis, *keiretsu* firms’ strategic emphasis shifted towards ‘knowledge-intensive’ (Johnson 1982:288) “industries with relatively modest energy and raw materials requirements and comparatively high value added per yen spent on imported inputs. They accelerated the investment in high value-added sectors, such as "sophisticated machinery (including robots and aircraft), transport equipment, fabricated metal products, microelectronics, fiber optics, lasers, atomic energy, fish farming, ocean development, pollution control, solar energy, etc." (Carson and Traynor 1997:213). Dore (1983) argued that during this period *keiretsu* firms also went through a major restructuring process to reduce the number of non-performing firms through mergers or closing down factories in the shipbuilding and petrochemicals industries.

MITI used personal connections to implement a policy of encouraging the rapid development of strategic sectors. After WWII, MITI focused on the coal and steel industries, and then they shifted their support toward heavy industries, mostly to chemicals, shipbuilding and automobiles. By the late 1970s after the major oil crisis, this support mostly concentrated on the high-tech sector and electronics. "The oil shock strongly challenged the Japanese perception of the optimal industrial structure centered on heavy-chemical industries. MITI started two important projects aimed at reducing the dependence of the Japanese economy on oil. It started the Sunshine Plan in 1974 which focused on developing a substitute for oil, and the Moonlight Plan in 1978, which emphasized energy-saving technology. In the meantime, the Japanese quickly shifted their industrial structure to high-tech industries. During the 1970s and 1980s, the relatively strong growth of the Japanese economy [was] supported by the shift toward high technology industries" (Morris-Suzuki 1989).

Cowling and Tomlinson (2000) argued that though MITI and the *keiretsu* worked very closely, over time MITI's influence on the *keiretsu* firms lessened. Japan's large firms, which sought to become global players, began to dispute MITI's powers and in many case *keiretsu* firms pursued their own interests instead of complying with MITI policies. For example Ito (1997:17) notes that "[i]n the early 1960s, MITI attempted to merge several automobile manufacturers into two groups of firms, arguing that there were too many automobile manufacturers in Japan." For similar reasons in the 1980s, MITI also encouraged the petrochemicals firms to reduce their capacity and to merge eleven petrochemical complexes into four. The *keiretsu* firms rejected MITI's policy recommendations and retained their self-sufficiency. "If MITI had succeeded in reducing their number, domestic competition would have been stifled and Japanese automobiles and chemicals industries might not have dominated the world market in the 1980s" (Ito 1997:17). Although significant changes have occurred since the 1970s, it has been argued that Japan's political economy has remained developmentalist in its fundamental characteristics (Yamamura and Streeck 2003:5).

The Bank-Based Financial System and *Keiretsu* Firms

"Since the Japanese corporate sector was the driving force behind the growth economy, the main focus of the Japanese financial system was to provide a favorable environment for the corporate sector" (Ouandlous and Philippatos 1999:8). During the high growth era, the Japanese banking system became strategically important in the Japanese government's policies to create substantial growth. According to Ito (2000:95-96), Japan's financial system was one of the most regulated and administratively controlled in the world. The Ministry of Finance (MoF) and The Bank of Japan (BoJ) were the main policy makers in the bank-based financial system. The implementation of macroeconomic and monetary policies in the financial market was carried out by these two government organizations.

The Japanese financial institutions were functionally separated, and the MoF strictly defined the scope of their activities. “Each segment of the banking industry serves a distinct segment of the market. With certain exceptions, players in one sector are not permitted to engage in business in any other sector” (Milhaupt and Miller 2000:248). Unlike the Anglo-American banking system, the Japanese banking system is systematically segmented into commercial banking and long-term credit banking. Also the Japanese commercial banks were separated into “city” and “regional” banks according to their branch networks. Most of their business was short and long term lending to Japanese corporations. City banks were by far the most powerful financial institutions in Japan. Regional banks, on the other hand, have strong ties with small and medium firms in their local area as well as with local government (Lapavitsas 1996:24).

During the post war high growth era, the Japanese government allowed only the long-term credit banks to raise funds through the issuance of long-term debt securities. City and regional banks were limited to issuing debentures. The trust banks were strictly separated from ordinary banks, and they were permitted to accept five-year loan trusts. Lapavitsas (1996) argued that with this policy, the MoF aimed to facilitate the flow of cheap long-term investment funds to industry by the long-term credit banks. The Bank of Japan tightly controlled the interest rate, money supply and foreign exchange rates to create the necessary capital to support industrial development. The Japanese government was subsidizing the banks to create low cost financing for industrial development. BoJ policies were structured to supply central bank credit to the commercial banking system. Under the central bank-based finance system, the BoJ injected massive amounts of capital into the commercial banking system by setting interest rates below market-clearing rates. Additionally, the Bank of Japan often injected significant amounts of capital into the group banks. These funds were used as extended industrial credits by firms closely affiliated to the banks, known as the “bank-led” companies, or *kinyu keiretsu* (Ozawa 1999:353).

MITI and the MoF collaborated to restructure the financial system to provide preferential long-term finance for *keiretsu* firms’ investments. In response to a perceived capital demand from the *keiretsu* and other firms, and also to promote the development of capital-intensive heavy and chemical industries after WWII, the government established the long-term Credit Bank of Japan (Nihon Choki Shinyo Ginko) and the Development Bank of Japan (Nihon Kaihatsu Ginko). Lapavitsas (1997) argued that, “with this policy, the MoF aimed to facilitate the flow of cheap long-term investment funds to industry from the long-term credit banks. The long-term credit banks were systematically providing significant amounts of cheap funds for the *keiretsus’* industrial investment. Cheap BoJ funds and low interest rates created a stable environment for the long-term credit banks and city banks to transfer massive amounts of cheap money to the *keiretsu* firms to invest in the capital-intensive heavy engineering and chemical industries.”

The Japanese government also played a very significant role in the direct financing of *keiretsu* development projects. The government mostly provided money for *keiretsu* development projects through the Japan Development Bank, or through direct lending to *keiretsu* financial institutions such as the city banks. The Japanese Development Bank enabled funds to be directed from the postal savings system to MITI's designated "strategic industries" (Cowling and Tomlinson 2000:364). "Tokyo provided 18.7 percent of all funds to the non-financial sector between 1970 and 1975" (Sato 1985:105). As Ozawa (1999) has argued, Japan's high-growth policy was heavily dependent on the banks' ability to supply the necessary capital to corporations to invest in capital-intensive industries. Those kind of large-scale capital-intensive investments entailed high financial risks; therefore, without government financial support and guarantees, *keiretsu* firms and banks might have been unwilling to invest large-scale capital in the heavy and chemical industries.

The BoJ was systematically providing funds for *keiretsu* industrial investment, especially in the large-scale capital-intensive, chemical and heavy engineering sectors. They subsidized the *keiretsu* group banks by keeping the official BoJ's discount rate lower than the inter-bank deposit rate and allowing banks to keep their equity to asset ratio lower than the required level. With these policies, the MoF endeavored to increase the banks' lending capacities. These policies increased the risk of bank failure, but banks were willing to take risks because they expected BoJ support. All the banks were strategically very important for the government. And neither MITI nor the MoF could allow any bank failures. Ozawa (1999:2) believed that "the government would always come to the rescue if something ever went wrong to threaten the banks' financial health."

Kanaya and Woo (2000) argue that the Ministry of Finance developed distinctive formal and informal approaches to avoid bank failures such as the implicit blanket protection of deposits and the 'convoy system', "[r]ather than rely on the formal legal mechanisms supplied by the deposit insurance system" (Milhaupt and Miller 2000:249). As an alternative to direct capital injections through a deposit insurance system during a crisis at a bank, the government amalgamated the financially troubled bank with a stronger bank. "The MoF encouraged stronger, healthier banks to absorb insolvent institutions—called the *'hogacho'* rescue operation—through informal, administratively orchestrated bank purchase and assumption (P&A) transactions" (Kawai 2005:317). With the convoy system, "all banks were tied to each other and thereby ultimately in the same liquidity situation … this bank domination leads to governmental hesitance and regulatory forbearance" (Svensson et al. 2006:66). Most banks agreed to be part of the convoy system because they felt more secure. Even though they had to rescue financially troubled banks by injecting their own capital at the end of the rescue operation, they had the right to take over the failed bank's branch rights. Since the opening of new branches was strictly controlled and limited by the MoF, taking over a bank's branch rights were very important for banks to increase their market share.

The Liberalization Process in the Japanese Economy during the mid 1970s and its Impact on the *Keiretsu* Firms Corporate Finance and Governance Practice

The *keiretsu* firms' overseas investments were highly regulated by MITI until the end of the high growth era due to the government policy of protecting Japan's foreign exchange reserves and avoiding balance of payments difficulties (Bilgin 1982:257). During this period, only the few *keiretsu* firms in the mining industry and some other small firms in low technology, labor intensive and declining industries such as textiles, manufacturing and shipbuilding were allowed to invest overseas and subsidized by the Japanese government to do so. Dicken, (1998), and Cowling and Tomlinson (2000) argue that these investments were only allowed as long as they were favorable to the long-term strategic interests of the Japanese economy. For example, Kojima noted that, during the 1960s and 1970s, Mitsubishi, Mitsui and other major companies in the mining industry were allowed by MITI to invest overseas, mostly in resource-rich countries with abundant low-cost labor in East Asia, and South America to provide the necessary raw materials for the Japanese heavy and chemical industries.

Due to the liberalization process in the Japanese economy during the mid 1970s, the Japanese government began to relax its control on overseas investments, so that *keiretsu* firms were able to freely expand their global interests. The substantial capital accumulation because of the trade surplus of the *keiretsu* firms during the high growth era, along with the liberalization process, made *keiretsu* firms able to pursue their own strategic interests, free from limitations imposed by MITI. As a consequence, the *keiretsu* firms shifted their investment strategy from resources and cheap labor in developing countries to market-oriented, technology-based investments in industrialized countries (Yoon 1990:10). During this period, a number of factors encouraged the *keiretsu* and other Japanese firms to invest significantly in the more sophisticated consumer markets of North America and Europe (Cowling and Tomlinson 2000:368).

The first oil shock, the Nixon shock, and subsequently the Plaza Accord, which increased production costs in Japan relative to overseas, and also the increasing trade barriers due to regional organizations such as the EC and NAFTA, forced the *keiretsu* firms' managements to restructure their growth strategies in foreign trade and foreign investment. As a consequence, they decided to move some of their higher value-added sector production facilities overseas to overcome trade barriers and to reduce their production costs, so as to be more competitive in the global market. Over time, these firms have systematically increased their offshore production capacity compared with their domestic operations. The Japanese consumer electronics, petrochemical, steel, car and shipbuilding industries are the main sectors in which "exports are increasingly being replaced by overseas production, while the Japanese home market is gradually being supplied by Japanese affiliates, predominantly based in East Asia" (Cowling and Tomlinson, 2000:373). Yoon (1990:6) argued that the characteristics of Japanese FDI were associated with Japan's industrial transformation from labor-intensive, low-tech, and low-growth sectors to high-tech and high-growth sectors. In the process of structural adjustment, such macroeconomic forces as factor scarcities at home, an uncertain foreign supply of key resources, and a decline in the competitiveness of

Japanese labor-intensive goods prompted Japanese firms to invest abroad.

Cowling and Tomlinson (2000:368) have argued that "overseas production has had many advantages for *keiretsu* firms, but has had severe effects on Japan's domestic industrial sector. In particular, there are now genuine concerns that the expansion of overseas production has exacerbated a "hollowing out" of Japanese industry which, in the long term, will lead to relative economic decline and stagnation. The global sourcing strategies of the apex firms in the *keiretsu* network have weakened the traditional links between the main banks, the apex firms, and their suppliers, and also caused major structural demand problems for the smaller firms within the supply-chain network." As the *keiretsu* firms have outsourced their production globally, they are also able to outsource their supply chains on a worldwide scale and have started to serve Japan's domestic markets from their offshore bases, primarily from those in East Asia. Therefore many local suppliers who have not been able to relocate their production facilities have lost their business with the apex firms (Cowling and Tomlinson 2002: 374-381). The *keiretsu* firms' management strategies of outsourcing and downsizing have precipitated significant structural changes in Japanese corporate finance and governance practice. Those structural changes were one of the main reasons behind the financial crisis in the 1990s and Japan's current economic stagnation. Cowling and Tomlinson (2002: 374-377) have argued that "the negative impact of *keiretsu* outsourcing also appears consistent with the decline, in both nominal and real terms, of Japan's persistent long running trade surplus. This in turn has contributed to the stagnant growth in domestic output. …. In the long run, the demise of the *keiretsu* relationships and the transfer of higher value-added activities overseas will reduce both total factor productivity growth and international competitiveness."

Conclusion

Until the Showa Financial Crisis of 1927, the capital markets, primarily the equity market, had been the main source of capital for the many large industrial firms. Corporate bond issues rose rapidly during the Meiji era and became the main source of external funds for large industrial firms in the early twentieth century. Most of the big corporations financed their investment through the Japanese equity and bond markets. During this era, individuals, mostly the *zaibatsu* families, owned and controlled the industrial and financial capital; intense conflicts between the members of the ruling elite and between individuals within social classes characterized the era.

Between the Showa Financial Crisis in 1927 and the Korean War in the 1950s, control of financial and industrial capital shifted from the zaibatsu families to financial and industrial institutions. This major transformation in the ownership and the capital structure of corporations and banks lessened the shareholders' influence on the governance of corporations and the state. The bank-centered cross-shareholding system also reduced the level of shareholder influence on managerial decision making and led to greater autonomy for the directors. Because the majority of corporations were owned by other corporations and financial institutions, Japanese managers became "the agents of the corporate social organs rather than of individual property holders." This autonomy gave managers a greater ability to cooperate with bureaucracy in order to run the corporations in alignment with the long term interests of Japanese capitalism. Thus, during the high growth era, as an autonomic new ruling class, the corporate managers and bureaucrats were able to cooperate and pragmatically transform the socioeconomic structure of Japan to align with the long term interests of Japanese capitalism — in terms of their perceived common interest — without causing any serious social or class struggles.

The close relationship between the government, *keiretsu* firms and financial institutions allowed Japan to complete its industrial development process successfully. The 1970s was the turning point for the Japanese corporate governance and financial system. During the high growth era, the Japanese economy created a unique corporate finance and governance model based on the main bank, *keiretsu* and cross-shareholding systems (Aoki 1990, 1994). Therefore Japanese capitalism is frequently cited as an alternative model to the Anglo-American style of free market capitalism. Many developing countries in the world have closely examined the system and tried to adapt the Japanese model to their countries. The Japanese corporate governance and financial model worked very well during the 1960s and early 1970s. However, following the end of the high growth era Japanese capitalism "entered a new period of accumulation characterized by slower growth and financial instability" (Lapavitsas 1997:45). In this period Japanese financial institutions and *keiretsu* firms had to face domestic and international structural challenges, which occurred because of the structural changes in the *keiretsu* production system such as outsourcing and downsizing, as well as other monetary and financial factors due to the major financial liberalization reforms. Prowse (1992:1139) points out, "the dramatic changes in the Japanese corporate sector in the last decades, including improved access to global capital markets and the deregulation of domestic capital markets, the slowing of growth opportunities for Japanese firms in their traditional lines of business and the huge build-up of cash on Japanese firms' balance sheets, may have weakened the governance mechanism in the *keiretsu* groups."

Those structural changes had important repercussions in the system and forced Japanese *keiretsu* firms and financial intuitions to adapt to the new more competitive domestic and international environment. "The decline in the use of the attributes of Japanese corporate culture has led firms to examine their corporate structures and to place greater emphasis on profitability and the return on investments" (Toda and McCarty 2005:200).

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